Losses on a change of control

The recently announced proposed changes to the rules on carried forward losses on a change of ownership are welcome, but many pitfalls remain for the unwary.

SUMMARY OF THE CURRENT RULES

Part 14 CTA 2010 restricts the availability of relief for various corporation tax losses when companies change ownership.

Relief is restricted for trading losses in two situations: first, when in any period of three years there is both a change in company ownership and there is a major change in the nature or conduct of a trade carried on by that company; and, secondly, where there is a change in company ownership which occurs at any time after the scale of the company’s trading activities has become small or negligible and before any significant revival of the trade.

A change in company ownership occurs when someone acquires more than half of a company’s ordinary share capital. However, a change in the direct ownership of a company is disregarded if the company concerned was a 75% subsidiary of the same ultimate parent company immediately before and after a change of ownership.

Similar rules apply for various other losses including, in particular, management expenses and loan relationship debits where there is a change in the ownership of a company with an investment business. These rules go further than those for trading losses, as they apply not only where there is a major change in the investment business (or it becomes small or negligible) but also where there is “a significant increase in the amount of a company’s capital” following a change in ownership.

The test for determining whether there has been such an increase is not entirely straightforward, but broadly speaking applies where, after the change in ownership, the capital (debt and equity) of the company either doubles or increases by at least £1 million. For this purpose it is necessary to compare the highest capital amount for a continuous 60 day period in the year prior to the change of ownership (or, if lower, the capital immediately prior to the change in ownership) with the highest capital amount for a continuous 60 day period in the three years after the change of ownership. To put it another way, one works out the pre-change capital amount and then one needs to work very hard to ensure that that amount is not exceeded for more than 59 days in the three years after the change – easier said than done!

WHAT IS THE UNDERLYING POLICY BEHIND THESE RULES?

The HMRC Manuals¹ state that the provisions for investment companies were introduced primarily to counter management expenses buying. Their effect, however, is far wider than that. For example, these rules apply on
a takeover of a UK owned listed group. There is a very strong case for arguing that these rules should not apply where the change of ownership is as a result of a bona fide commercial transaction which does not have any tax motivation or purpose.

PROPOSED FINANCE BILL CHANGES

The proposed changes to be included in the Finance Bill 2014 are not a complete solution to the problems generated by these rules, but they are a good start: they deal with some of the niggles whilst being relatively uncontroversial from a policy perspective.

The first proposal is to amend the definition of “a significant increase in the amount of a company’s capital”. The existing test takes no account of the size of the company concerned and is ridiculously tight in the context of large M&A transactions, where the capital of the holding company of a group might naturally fluctuate outside the £1 million threshold on a daily basis, without there being any underlying change in the activities of the underlying group. The new test would allow such a company’s capital to increase by 25% before it amounted to a significant increase. Whilst it might have been hoped that an even higher percentage increase would have been permitted, the change does at least provide a more workable threshold to work within.

The second change permits the insertion of a new group holding company at the top of the group without triggering a change of ownership, provided that various conditions are met. It always seemed difficult to justify why it was possible to insert new intermediate holding companies, but inserting a new holding company at the top of the group, owned by exactly the same shareholders as the old company, should amount to a change of ownership. The conditions are quite onerous. First, the new company’s share capital must be an exact mirror image of the old company’s. This is similar to the test for stamp duty relief under s77 Finance Act 1986, although it is hoped that HMRC will be persuaded to include some of the existing relaxation in Section 77 in this new provision, in order to make it workable in practice.

Secondly, the new holding company must not have issued any shares other than subscriber shares or begun to carry on or make preparations for carrying on any trade or business prior to the acquisition. This could cause problems in practice if, for example, the new company puts cash on deposit (the cash subscribed for the subscriber shares, for example), enters into any contractual obligations, engages professional advisors or registers for VAT prior to the acquisition. It is to be hoped that HMRC are persuaded that these additional requirements are unnecessary. Otherwise tax advisors are going to have to spend considerable amounts of time policing the activities of the NewCo prior to the transaction!

Both these changes are currently proposed to have effect in relation to any change of ownership which occurs on or after 1 April 2014. Whilst this seems correct in relation to the new holding company change, it is not clear why companies that are still within the three year period post a change of ownership should not have the benefit of the relaxation to the significant increase definition, even if the relaxation only applied for the remainder of the three year period.

WHERE ARE THERE STILL PROBLEMS?

Even with the new more generous threshold for significant increase in capital, the task of monitoring these rules and ensuring that a significant increase of capital does not occur is an onerous one.
First, it is necessary to determine the company’s “Amount A”, which is the target pre-change capital amount against which the post-change capital is tested. In the context of a complex holding company, this is not entirely straightforward. It includes paid up share capital and share premium, which should be relatively straightforward to ascertain. But it also includes loan capital and debts within section 453(2) CTA 2010 (a cross reference that is not entirely straightforward to apply) and, according to HMRC Manuals², includes any interest on those debts, although presumably only to the extent that that interest is due and payable (otherwise it would not amount to a debt). It also has to be calculated in Sterling, although HMRC apparently believe that the historic exchange rate when the capital was raised or the debt incurred should be used. It is not clear how this rule is to be applied to any accrued interest on the debt.

Secondly, having calculated its Amount A, in the three years post change of ownership the company needs to try to ensure that it does not increase its capital above the relevant threshold. This may not be straightforward. For example, as a result of the takeover the company may need to cash settle share options or fund significant make-whole amounts payable on the early repayment of debt under change of control provisions. How is this achieved without the company taking on additional borrowings and therefore increasing its capital?

Similarly, after a merger there may well be a strong commercial desire to consolidate the two groups’ operations or to make further acquisitions. Can this be achieved without the company issuing additional shares or debt?

Whilst it is usually possible to structure around these problems, three years can seem a very long time in these situations.

WHAT DO OTHER JURISDICTIONS DO?

The UK is not alone. Germany, Italy, Spain, the Netherlands and the US, for example, all have rules restricting the carry forward of losses after a change of ownership. And perhaps we should not moan too much about the complexities of monitoring the potential application of the UK rules. In the US, loss limitations are triggered if one or more 5% shareholders increase their stock ownership by an aggregate of 50% over a rolling three year period. Neither the shareholders nor the shifts in ownership need to be related. Accordingly, widely held corporations must continuously monitor the ownership of their shares to determine whether increases in ownership by substantial (but potentially unrelated) shareholders trip the rules.

It also needs to be borne in mind that, in the current economic climate, governments are keen to preserve tax revenues, on which the utilisation of carried forward losses are a direct hit. A recent international trend is a rule preventing carry forward losses being offset so as to eliminate the entire profits. In France and Germany, so-called “minimum taxation” rules ensure, broadly speaking, that a proportion (40% in Germany and 50% in France) of profits in excess of 1 million Euros remain taxable; in Italy, losses can be used to offset an amount not exceeding 80% of the taxable income of any fiscal year, and, in Spain, the upper limits vary according to companies’ turnover such that, for instance, carry-forward losses may not exceed 50% of the current fiscal year tax base for companies with a turnover in excess of EUR60 million.

² CTM08750
CONCLUSION

If these rules are intended to be focused on loss buying, their reach, even after the proposed changes, is still too broad. Until this changes, however, a UK group with significant losses that is subject to a change of control may have to devote significant resources to manage its post-transaction capital position.

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